

May 23, 2001

Sent via e-mail, hand delivery and/or U.S. Mail

Mary L. Cottrell, Secretary

Massachusetts Department of Telecommunications and Energy

One South Station, 2nd Floor

Boston, MA 02110

Re: Verizon New England, Inc. d/b/a Verizon Massachusetts' Alternative Regulation Plan Review, D.T.E. 01-31

Dear Secretary Cottrell:

Enclosed for filing please find the Attorney General's Comments on the Scope of the Investigation into Verizon New England d/b/a Verizon Massachusetts' Alternative

Regulation Plan in the above referenced proceeding, together with a Certificate of Service.

Sincerely,

Karlen J. Reed

Assistant Attorney General

Regulated Industries Division

Office of the Attorney General

200 Portland Street, 4th Floor

Boston, MA 02114

(617) 727-2200 ext. 3436

KJR/kr

Enc.

cc: Paula Foley, Esq., Hearing Officer (w/enc.)

Service List for D.T.E. 01-31 (w/enc.)

TABLE OF CONTENTS

I. Introduction Page 1

II . Background Page 2

A. Verizon's Proposal Page 2

B. Verizon's Current Price Cap Plan Page 3

III. The Department Needs To Determine A Cost Of Service Page 4

IV. Additional Considerations Page 7

A. The DTE Must Determine the Extent of Actual Competition Page 7

B. Verizon Must Show That Its Proposal Will Keep Its Remaining Regulated Retail Rates
"Just and Reasonable" Page 8

C. The DTE Must Include Alternatives to the Proposal Page 8

V. Conclusion Page 9

COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

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its own Motion into the Appropriate Regulatory Plan to succeed Price Cap)
Regulation for Verizon New England, Inc. d/b/a Verizon Massachusetts') D.T.E. 01-31
intrastate retail telecommunications services in the Commonwealth)
of Massachusetts)

**ATTORNEY GENERAL'S COMMENTS ON THE SCOPE OF THE
INVESTIGATION INTO VERIZON NEW ENGLAND D/B/A VERIZON
MASSACHUSETTS' ALTERNATIVE REGULATION PLAN**

THOMAS F. REILLY

ATTORNEY GENERAL

By: Karlen J. Reed

Joseph W. Rogers

Wilner Borgella, Jr.

Assistant Attorney General

Regulated Industries Division

Public Protection Bureau

200 Portland Street

Boston, MA 02114

(617) 727-2200

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I. Introduction

Thomas F. Reilly, the Attorney General of the Commonwealth of Massachusetts ("Attorney General"), in response to the Hearing Officer's procedural schedules of May 4 and 7, 2001, submits these comments on the scope of the investigation by the Massachusetts Department of Telecommunications and Energy ("DTE") to consider the rate plan proposed by Verizon New England d/b/a Verizon Massachusetts ("Verizon" or "the Company") in *Verizon's Alternative Regulation Plan*, DTE 01-31 ("DTE 01-31"). As an investigation under G.L. c. 159, § 20, the scope must be sufficient to permit the DTE to make a reasoned finding based on substantial evidence that Verizon's plan will produce rates that are "just and reasonable."

In the circumstances of the current proposal, the Attorney General submits that the required scope of the investigation encompass at a minimum two questions:

- (1) Whether the Company's current rates are "just and reasonable," and
- (2) Whether the rates that could result from the adoption of Verizon's proposed plan are likely to be "just and reasonable."

With regard to the first inquiry, the DTE will need to determine the costs incurred by Verizon to provide service. With regard to the second inquiry, the Department will need to determine the extent to which market forces exist in the Commonwealth, as well as the reasonableness of the pricing rules included within Verizon's Proposal. Finally, the DTE should include an examination of alternatives to Verizon's Proposal.

II . Background

A. Verizon's Proposal

On February 27, 2001, the DTE directed Verizon to file a proposed retail price plan which included: "(1) a component for regulating or deregulating retail prices; (2) a plan for regulating service quality; and (3) a plan for intrastate access charge reform similar to that approved by the Federal Communications Commission ('FCC') for interstate charges."⁽¹⁾ On April 12, 2001, Verizon filed a Proposal under which the Company would be allowed to: (1) eliminate the separate monthly charge to its residential customers for Touch-tone service, to increase its basic monthly service charge by 47¢ per month to recoup the forgone Touch-tone revenues, and to then freeze its residential basic monthly and local usage rates for three years; (2) change its other prices for optional services provided to residential consumers without any review so long as the amount of any increases is offset by decreases in the prices of other optional residential services; (3) be freed from any state regulation whatsoever of the prices it charges all its other retail customers, including business customers; (4) be freed from the current requirement that it reduce its rates each year to the extent that inflation is less than 4.1 percent; and (5) conduct geographic deaveraging for both residential and business services.

B. Verizon's Current Price Cap Plan

In 1995, the DPU adopted a price cap model or plan ("Price Cap Plan") to govern NYNEX's intrastate retail telephone rates. *NYNEX*, D.P.U. 94-50, Order (May 12, 1995) ("Price Cap Order"). As the DTE stated in its order opening the investigation into DTE 01-31, consumers have received the benefit of over \$296 million in rate reductions over the term of the Price Cap Plan.⁽²⁾ The Price Cap Plan employs a formula to determine the level of Verizon's retail rates, adjusted for the annual rate of inflation and exogenous costs which are beyond the Company's control. That formula includes a productivity

offset, which represents a productivity differential between Verizon's productivity and the productivity of the economy as a whole minus any retail service penalty adjustment. The productivity offset for the current Price Cap Plan is fixed at 4.1 percent, subject to service quality penalties assessed in each annual filing.⁽³⁾ The productivity offset was designed to represent an achievable level of efficiency growth for Verizon and a reasonable opportunity for above-average returns for above-average performance. The DTE concluded that the 4.1 percent offset "should prevent monopoly pricing and produce just and reasonable rates throughout the term of the plan."⁽⁴⁾ The Price Cap Plan includes service quality terms to ensure that the Company does not cut costs to the detriment of service quality.⁽⁵⁾ Under these terms, failure to achieve a minimum level of service quality in regards to twelve measures⁽⁶⁾ will result in an increase in the productivity factor in Verizon's subsequent compliance filing by one-twelfth of one percent (.083 percent). By its own terms the Price Cap Plan expires August 2001.

Although the most readily available public reports of Verizon's financial performance show that the Company's New England operations achieved a profit rate of nearly thirty percent in 2000 (27.53 percent),⁽⁷⁾ the Company did not include within its filing any information concerning the performance of its regulated retail operations in Massachusetts.

III. The Department Needs To Determine A Cost Of Service

Verizon has filed for a change in rates pursuant to G.L. 159 § 20. Pursuant to the statutory mandate, Verizon bears the burden of proof that its Proposal will result in "just and reasonable" rates. In the typical rate case, the lawfulness of the rates would be determined, at least in part, by reference to the costs necessary to provide the service.

The Price Cap Plan which produced the current rates expires August 2001. The Company's Proposal will merely lay a new plan upon its current rates. In order to determine if this Proposal produces "reasonable rates" over its term, the Department must review both the current rates and the rates that will be produced by the Proposal.

A utility rate cannot be deemed "reasonable" simply because an expert agency says it is. The legislative framework requires that the Department assess Verizon's Proposal to determine whether it provides adequate compensation for services rendered, and is not unjustly discriminatory, unduly preferential, or otherwise in violation of any law.⁽⁸⁾ G.L. c. 159, §§ 14 and 20. Although the Department has discretion in the selection of a methodology,⁽⁹⁾ that discretion must be exercised within the standards and directives of G.L. Chapter 159. Therefore, the Department is required to announce the criteria that will govern its review of the Verizon proposal, and in its final order, explain how the particular rate order reflects application of these criteria to the facts of the case.

In its Price Cap Order in DPU 94-50, the Department concluded that a comprehensive earnings review, which included a cost of service study, was necessary to determine whether NYNEX's current rates were "just and reasonable" as required by G.L. Chapter 159. Implicit in that determination was the recognition that while the Company's rates are

presumptively reasonable until changed or modified by the Department, "those rates might not be appropriate rates for the starting point under price cap regulation, should it appear that the Company was earning more than a reasonable return."⁽¹⁰⁾ A review of the Company's current rates is even more imperative in this case because ten years has passed since the last comprehensive review and because the Price Cap plan will soon expire leaving no presumption concerning the reasonableness of the current rates. A determination of whether Verizon's rates are just and reasonable is a relative concept based on the costs that Verizon incurs in bringing the retail services to its Massachusetts customers, *i.e.*, whether the price of a particular type of telephone service is just and reasonable depends on the cost incurred to produce that service.⁽¹¹⁾

Therefore the Department's investigation must support:

(1) a determination of whether Verizon's current rates are "just and reasonable" pursuant to the requirements of G.L. c. 159, and are an appropriate starting point for Verizon's new Proposal;

(2) a determination of whether the Massachusetts market for business telephone service is sufficiently competitive to allow Verizon the pricing flexibility it has requested thereby yielding "just and reasonable" rates under the Proposal; and

(3) whether Verizon's other retail rates will continue to be "just and reasonable" under its Proposal.

The DTE must determine Verizon's cost of service in order to adequately judge whether the prices produced by Verizon's proposal are just and reasonable. The Attorney General submits that the DTE should order Verizon to file a fully allocated cost of service study using a calendar year 2000 test year, sufficient for the DTE to conduct a full-scale revenue requirement and rate structure investigation. Publicly available information indicates that Verizon may be earning a rate of return on average equity that approaches thirty percent. A cost of service study would allow the DTE to determine the Company's actual earnings and set appropriate rates for the future.

IV. Additional Considerations

A. The DTE Must Determine the Extent of Actual Competition

An important component of Verizon's Proposal is to eliminate rate regulation for retail services outside the residential market. The Company supports this Proposal with a bald assertion that the business sector is open to competition and that therefore rate regulation

is not needed. The scope of the current investigation must include a close examination of market conditions and existing competition in Massachusetts. The DTE and the FCC may have concluded that Verizon had demonstrated that the market for local competition was sufficiently "open" to permit it to enter the long distance market under the terms of the Telecommunications Act of 1996,⁽¹²⁾ but it should be emphasized that demonstrating that a market is open to competition is simply not the same as demonstrating that actual competition in that market is sufficiently robust to negate the need for rate regulation. Here, Verizon must demonstrate that *all* business customers *in every corner of the state* have meaningful competitive options that will provide adequate protection against Verizon abuses of its long entrenched monopoly power.

B. Verizon Must Show That Its Proposal Will Keep Its Remaining Regulated Retail Rates "Just and Reasonable"

In its Proposal, Verizon proposes to eliminate four of the five current pricing rules adopted to keep Verizon's rates "just and reasonable." Verizon must demonstrate why those pricing rules should be eliminated.⁽¹³⁾ Among other things, the Price Cap Plan provides for an annual 4.1 percent rate reduction (in real dollars). Verizon must demonstrate that eliminating this and other current pricing rules is in the public interest and must demonstrate by substantial evidence that the requested pricing freedom will ensure that the retail rates will be just and reasonable.

C. The DTE Must Include Alternatives to the Proposal

The DTE should provide for consideration of alternatives to Verizon's Proposal. In the interests of developing an appropriate regulatory plan for Massachusetts consumers, the Attorney General urges the DTE to examine all alternatives. Interested parties should be permitted an opportunity to submit plans for the DTE's consideration. Restricting the scope of this investigation to Verizon's Proposal, without considering alternatives, will unnecessarily limit the DTE's selection process. The public interest requires a consideration of alternatives.

V. Conclusion

For the reasons stated herein, the Attorney General urges the DTE to include in the scope of this investigation a revenue requirement or, at a minimum, an earnings review that includes a cost of service study to determine whether Verizon's current and future rates are just and reasonable. The DTE needs to determine the extent to which market forces exist in the Commonwealth, as well as the reasonableness of the pricing rules which will

remain under Verizon's Proposal. Finally, the DTE should include in its scope other alternatives to the Proposal.

Respectfully submitted,

THOMAS F. REILLY

ATTORNEY GENERAL

By: _____

Karlen J. Reed

Joseph W. Rogers

Wilner Borgella, Jr.

Assistant Attorneys General Regulated Industries Division

Office of the Attorney General

200 Portland Street, 4th Floor

Boston, MA 02114

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CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated in the official service list compiled by the Secretary of the Department of Telecommunications and Energy in this proceeding by either hand delivery, mail, and/or e-mail.

Dated at Boston this 23rd day of May 2001.

Karlen J. Reed

Assistant Attorney General

Regulated Industries Division

200 Portland Street, 4th Floor

Boston, MA 02114

(617) 727-2200

1. *Verizon's Alternative Regulation Plan*, DTE 01-31, Vote and Order to Open Investigation (February 27, 2001) at 1.

2. *Id.*

3. The 4.1 percent figure consists of: (1) a two percent productivity factor (using a long-term average), (2) an input price differential of one-tenth of one percent; (3) a one percent stretch factor (also called a "consumer dividend," a productivity dividend that reflects expected productivity increases); and (4) a one percent factor to account for accumulated inefficiencies DPU 94-50 Order (May 12, 1995) ("Price Cap Order"), at 167-168.

4. Price Cap Order at 272.

5. *Bell Atlantic's Fifth Price Cap Compliance Filing*, DTE 99-102, Order (Aug. 3, 2000) at 8.

6. The 12 service items, grouped into three clusters, are as follows:

Maintenance Service: 1) Network Trouble Reports per hundred lines; 2) Percent of troubles cleared within 24 hours - residence; and 3) Percent of troubles cleared within 24 hours - business.

Installation Service: 4) Percent appointments missed company reasons - total customers; 5) percent appointments missed company reasons - residence customers; 6) Percent appointments missed - company facilities; and 7) Installation troubles per 100 inward orders.

Service Response Items: 8) Directory assistance - average speed of answer; 9) Customer service bureau - average speed of answer; 10) Toll and assist - average speed of answer; 11) Residence service level; and 12) Business service level.

7. Verizon New England, Inc., Securities Exchange Commission filing, Form 10-K405 (March 30, 2001).

8. "[F]rom the earliest cases, the end of public utility regulation has been recognized to be the protection of consumers from exorbitant rates." *Washington Gas Light Company v. Baker*, 188 F.2d 11, 15 (1950).

9. "So long as the public interest - i.e., that of investors and consumers - is safeguarded, it seems that the Commission may formulate its own standards. But there are limits inherent in the statutory mandate that rates be 'reasonable, just and non-discriminatory'." *Washington Gas Light Company v. Baker*, 188 F.2d 11, 15 (1950); *Weld v. Gas &*

Electric Light Communications, 197 Mass. 556, 558 (1908) (The Department has a legislative mandate to "prevent the abuse of monopoly").

10. Price Cap Order at 276. The Department allowed the parties "the full opportunity to explore all issues related to the Company's earnings." *Id.* at 277.

11. For the purposes of "cast-off" rates, *i.e.*, rates that are intended to be reviewed as a starting point for a new regulatory regime, "whether a particular rate is 'unjust' or 'unreasonable' will depend to some extent on what is a fair rate of return given the risks under a particular rate-setting system, and on the amount of capital upon which the investors are entitled to earn that return." *Duquesne Light Company v. Barasch*, 109 S.Ct. 609, 617 (1989).

12. The Attorney General repeatedly urged both the DTE and the FCC to find that Verizon had not made the required showing. On May 14, 2001, the Attorney General appealed the FCC's April 16, 2001 order approving Verizon's entry into the long distance market under Section 271 of the Telecommunications Act. That appeal, docketed as Case No. 01-1209, and two other appeals (WorldCom - Case No. 01-1198, and ASCENT - Case No. 01-1206) have been consolidated under Case No. 01-1198 and are pending before the United States Court of Appeals for the District of Columbia Circuit.

13. Verizon's Proposal retains only the fifth pricing rule, which is the Service Quality Plan and Index, minus its penalty provisions relating to the productivity offset.